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China: Trade Surplus Opens New Opportunities

An Intelligence Assessment

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September 1982
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China: Trade Surplus Opens New Opportunities [redacted]

An Intelligence Assessment

This paper was prepared by [redacted] China Division, [redacted] Systems Development Staff, Office of East Asian Analysis. Comments and queries are welcome and may be addressed to the Chief, China Division, OEA, [redacted]

Secret
EA 82-10095
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China: Trade Surplus Opens New Opportunities [redacted] 25X

Key Judgments

Information available as of 10 August 1982 was used in this report.

We estimate that China will post a $5 billion trade surplus this year, topping last year's record of $3.8 billion. The surplus is a result of Beijing's policies of economic readjustment and reform of the foreign trade system, which have led to a pronounced decline in imports of producer goods, and a successful program of export expansion. [redacted] 25X

The surplus will lead to a significant strengthening of China's international finances. By the end of 1982, foreign exchange reserves, excluding gold, could approach $8 billion, and outstanding foreign debt probably will be reduced to about half the yearend 1981 level of $4.8 billion. Unlike many less developed countries, China has no problem servicing this debt. [redacted] 25X

In these circumstances the Chinese may feel less need to rely on equity financing of capital imports—typically, joint ventures—and will be able to switch to cash payments for better terms. By offering cash Beijing may also be able to acquire more advanced technology than it could obtain through joint ventures with foreign firms. [redacted] 25X

We believe that Beijing is also likely to invest more funds abroad, particularly in Hong Kong, where China's acquisition of real estate and industrial properties could have long-range implications for resolution of the British colony's political status. [redacted] 25X

Beijing may be beginning to use its large foreign exchange holdings to make selective purchases of equipment for its defense industries. [redacted] 25X

[redacted] 25X

Although US exports of soybeans, cotton, and synthetic fibers to China in 1982 will fall below 1981 levels, prospects for US sales of other goods and services are promising. The United States will remain China's principal grain supplier, with shipments totaling roughly 8.1 million tons this year. US sales of lumber will double this year, and China has expressed strong [redacted] 25X

interest in acquiring US commercial aircraft. China's strengthened payments position also will facilitate increased purchases of US oil equipment and petroleum exploration and development services. [redacted] 25X

We do not know how long China's strong financial position will last. It could evaporate quickly in the unlikely event Beijing returned to policies favoring much higher investment in heavy industry. This would result in sharp increases in imports of plant and equipment. Trade surpluses could be sustained if China continues to overcome the obstacles posed to its exports by sluggish international demand and quota restrictions that affect sales of Chinese goods in developed nation markets. [redacted] 25X

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China: Trade Surplus Opens New Opportunities [redacted]

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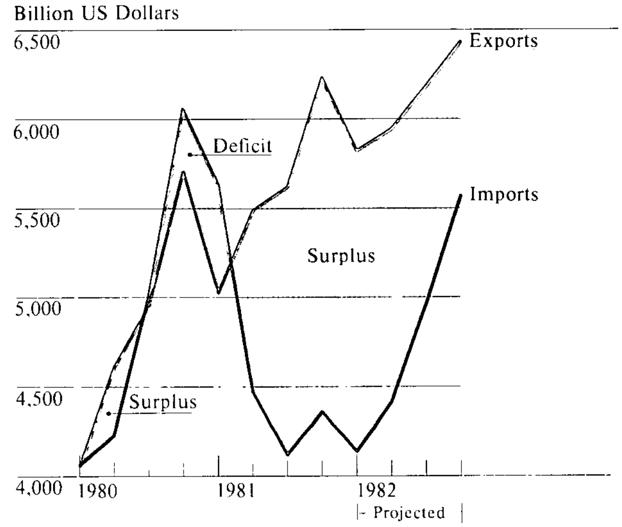
We estimate that China will post a $5 billion trade surplus this year, topping last year's record of $3.8 billion.[1] Although exports will grow at a slower pace than in 1981, imports, which have dropped off sharply since the fourth quarter of 1980, will remain depressed as the domestic economic slowdown and institutional reforms continue to restrict Chinese demand for foreign goods (see figure 1). We believe Chinese leaders are only now becoming aware of how severely the economic readjustments of the past two years have affected imports and will begin to boost purchases in the second half, too late to have much of an impact on deliveries this year. [redacted] 25X

Figure 1
China: Quarterly Exports and Imports



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Financial Impact

The trade surplus will enable China to accumulate large reserves of foreign exchange and reduce outstanding debt through the remainder of 1982. By yearend, reserves, excluding gold, could approach $8 billion, while foreign debt is likely to be reduced to about $2.5 billion, down from $4.8 billion at the end of December 1981 (see table 1). This debt will consist almost entirely of low-interest loans such as from the Japanese Overseas Economic Cooperation Fund, Western Export-Import Bank credits, and borrowings from the IMF and World Bank. This year, of course, China will not need recourse to IMF funds for balance-of-payments support. China is only seeking concessionary loans and will avoid incurring commercial debt for all but short-term trade financing. The debt-service ratio should drop to less than half the present 7.5-percent level, well below the average for less developed countries (LDCs). [redacted]

China's healthy financial situation could result in several changes in foreign economic policy. For example, it will put Beijing in a strong bargaining position in upcoming contract negotiations on development projects with Western multinationals—the Chinese may feel less need to rely on equity financing of capital imports and instead switch to cash payments to get better terms.[2] By offering cash, Beijing may be able to acquire more advanced technology than it could obtain through joint ventures. A number of Western firms now considering joint ventures are offering less than state-of-the-art technologies to China. [redacted] 25X1 25X

Beijing is also likely to invest more funds abroad, particularly in Hong Kong, where China's acquisition of real estate and industrial properties could have

[1] The trade data, obtained from official partner-country reporting, are in current US dollars, converted from partner-country currencies at the prevailing exchange rates. [redacted]

[2] The Chinese, for example, recently signed a $100 million cash contract with a Japanese firm for a plant to produce photographic film, after the Japanese firm refused to enter into a joint venture to produce the film. [redacted] 25X 25X

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Table 1
China: International Finances

Million US $

	1981				1982	1981	1982 Projected [a]
	I	II	III	IV	I		
Stocks (at end of period)							
Liquid assets [b]	2,376	3,824	3,936	5,048	5,460	5,048	8,000
Foreign exchange reserves	2,361	3,810	3,818	4,773	5,205	4,773	NA
SDRs	15	12	118	275	255	275	NA
Liquid liabilities	6,340	5,995	5,947	4,759	3,719	4,759	2,500
National bank liabilities	5,406	5,120	5,077	3,874	2,873	3,874	NA
IMF: Credit tranche	553	518	515	524	501	524	NA
Trust fund loans	381	357	355	361	345	361	NA
Flows (during period)							
Trade balance (f.o.b.)	−619	1,011	1,496	1,865	1,681	3,752	5,300
Increase in net liquidity	−651	1,791	162	2,300	1,452	3,602	5,300
Increase in liquid assets	22	1,446	114	1,112	412	2,694	3,000
Decrease in liquid liabilities	−673	345	48	1,188	1,040	908	2,300

[a] Projections for 1982 are rounded to nearest $100 million. Projection for increase in net liquidity assumes services, transfer payments, and investments net to zero. Projection for amortization of debt assumes China retains only low-interest loans.
[b] China also has 12.7 million ounces of gold, worth about $4 billion at current market prices, and Payments Agreements Assets amounting to about $800 million. Neither are considered very liquid.

[redacted] 25X

long-range implications for resolution of the British colony's political status. The impending visit to China by Prime Minister Thatcher will directly address Hong Kong's future for the first time. Expectations surrounding the visit have made investors in the colony jittery. In August, stock and real estate prices in Hong Kong plunged to a two-year low as investors reacted with dismay to a disclosure that the Hong Kong Government had signed two controversial land deals with China. These deals are perceived by some as a liquidation of British interests in the colony. [redacted] 25X

In addition, Beijing could relax its effort to prevent the importation of consumer goods. Since early in 1981, such imports have been attacked on the grounds that they squandered precious foreign exchange, competed with domestically produced goods, and created "bourgeois" values among the people. [redacted]

Beyond this year we do not know how long China's strong financial situation will last. It could evaporate quickly if China returned to a policy favoring investment in heavy industry. If the trade surpluses should become more persistent, however, Beijing could make other policy adjustments. The favorable trade balances could encourage Beijing to step up economic and military aid to LDCs, which in recent years has been slashed to bare bones. Beijing also could allocate more foreign exchange to procurement of equipment for defense, which, under the modernization program, has taken a backseat to the development of civilian industries. Even now, however, foreign exchange reserves are sufficient to enable China to make selective purchases of armaments and equipment for defense industries. [redacted] 25X

[redacted] 25X

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[redacted]

The turnabout in China's trade fortunes, however, could have one negative consequence. In bilateral trade negotiations, Beijing may find that Western nations are less receptive to arguments it has used in the past to obtain favorable treatment for China's exports. Among OECD (Organization for Economic Cooperation and Development) countries China is running significant bilateral trade deficits only with the United States, Australia, and Canada—its grain suppliers—and West Germany. Since mid-1981 China has moved into surplus with all other major European countries, and in the first quarter staked out a half-billion dollar surplus with Japan. Beijing's implicit threat to cut back imports from the EC if the EC does not remove barriers to imports of Chinese textiles, apparel, and other sensitive goods no longer will carry much weight. [redacted]

Origins of the Trade Surplus

China's movement from a position as a net debtor to that of a creditor stems both from Beijing's readjustment policy and from the decentralization of foreign trade. Until 1976, neither surpluses nor deficits were long tolerated—the former, because Beijing did not desire to accumulate any more foreign exchange than it needed to maintain an uninterrupted flow of imports; the latter, because Beijing did not want to become dependent on foreign debt. The authorities acted to correct any trade imbalance, generally within one quarter, by alternately applying either the brake or the throttle to imports. This was the most direct and immediate means to achieve balance, since the level of export revenues was subject to the vagaries of foreign demand and could be adjusted only over the longer term. As a result, quarterly imbalances seldom exceeded $200 million and generally were reversed in the following quarter (see figure 2). [redacted]

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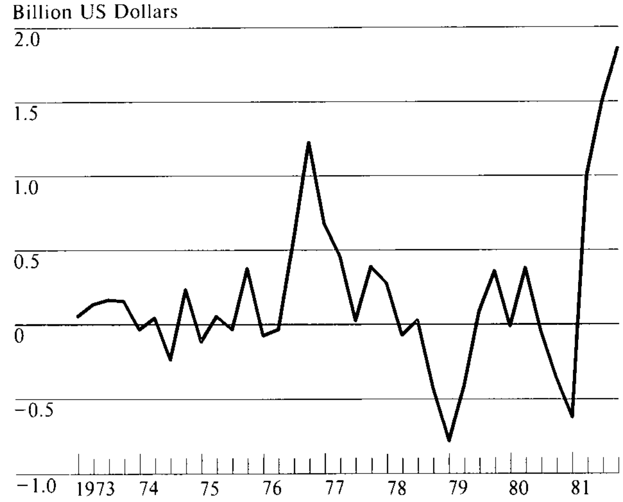
Figure 2
China: Quarterly Trade Balance, F.O.B.



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Since the death of Mao, however, Beijing has permitted much larger and longer swings in the trade balance. While exports have maintained steady and consistent growth, imports have fluctuated over broad cycles, producing quarterly surpluses in 1976-77, deficits in 1978-80, and once again record surpluses in 1981 and 1982. [redacted] 25

In part, this reflects a relaxation of Beijing's interventionist attitude toward foreign trade. Beijing seems content to let domestic economic developments determine the pace of imports, absorbing capital from abroad during periods of rapid industrial growth and amortizing foreign debt and building up reserves during slowdowns. The current decline in imports of capital goods appears to be caused more by the reductions in domestic investment that have accompanied the readjustment policies than by international financial constraints. When Beijing suspended contracts with Japan and West Germany for the Baoshan 25 steel mill and four petrochemical plants in February 1981, China had access to enough foreign exchange to pay for the plants, but insufficient domestic funds—because of sharp budget cuts—to pay for the local portion of the projects. Slower domestic growth has resulted in a buildup in inventories of steel, cotton, synthetic fabrics, and other producer goods, and hence a decline in imports of these goods. [redacted]

China's growing trade surplus also is related to policies Beijing instituted last year to remedy a major drain on foreign exchange that it believed would result from the decentralization of foreign trade. In January 1981 Beijing established a more favorable internal yuan-dollar exchange rate of 2.8 to 1 (compared with the official rate of 1.8 to 1) to provide incentives for domestic firms to expand exports, and to discourage imports. In March 1981 Beijing also imposed foreign exchange controls on local enterprises. Those regulations required enterprises to remit all deposits held in foreign banks to the Bank of China, thus cutting off an uncontrolled source of spending. Perhaps more importantly, under the regulations, hard currency loans to local enterprises had to be repaid in hard currency. Each Chinese firm could purchase imports only to the extent that it earned at least as much foreign exchange from its own exports. Initially, Beijing probably believed this policy was needed to provide a buffer of reserves against erratic imports under a more decentralized foreign trade system. Although Beijing has since permitted firms with surplus foreign exchange to sell their deposits to those in need of hard currency, in the absence of developed capital or foreign exchange markets, funds still are not flowing from the "haves" to the "have-nots." This dysfunction virtually assures a trade surplus. [redacted]

We believe the quality of China's trade statistics has also deteriorated as a result of the decentralization of trade, hampering Beijing's ability to respond quickly to any trade imbalance. Until recently, Beijing may not have realized that imports had dropped so dramatically. Official Chinese data for 1981—released three months later than normal—showed imports increasing 26 percent to $21.6 billion (on a c.i.f. basis), with exports and imports virtually in balance. This contrasted sharply with our own estimates from trade partner data, which showed imports falling to $18.6 billion (on an f.o.b. basis), producing a $3.8 billion surplus (see table 2). By May, Beijing probably realized that imports had plummeted. At that time, in his presentation of the economic plan for 1982, Yao Yilin called for an increase in imports and a slowdown in exports. Nevertheless, he forecast that this would "give rise to a deficit in foreign trade" this year. In July, however, even the Chinese statistics showed a record $2.4 billion surplus for the first half, with imports dropping 20 percent from a year ago. [redacted]

Table 2
China: Foreign Trade [a]

Million US $

	Exports		Imports	
	1980	1981	1980	1981
World	**19,300**	**22,400**	**19,400**	**18,600**
Non-Communist countries	17,400	20,700	17,500	17,100
Of which:				
Japan	4,140	5,030	5,110	5,105
United States	1,055	1,875	3,755	3,605
Western Europe	2,655	2,565	2,950	2,640
Hong Kong	4,400	5,270	1,250	1,965
Communist countries	1,900	1,700	1,900	1,500
Of which:				
USSR	230	130	295	115

[a] Area totals are rounded to nearest $100 million. Exports and imports are recorded f.o.b.

[redacted]

Accordingly, we believe the Chinese will take measures to boost imports in the last half of the year while restricting the growth of exports. [redacted]

Export Prospects

We expect exports will grow 8 to 10 percent this year, down from 16 percent in 1981 (see table 3). The slower growth is dictated both by domestic economic constraints and weak foreign demand. After remarkable growth rates of more than 30 percent per year in the late 1970s, China's exports now account for

Table 3
China: Exports, Imports, and Trade Balance [a]
Projected by Major Commodity Groupings

Million US $

	1981				1982 [b]				1979	1980	1981	1982 [b]
	I	II	III	IV	I	II	III	IV				
Trade balance	**−619**	**1,011**	**1,496**	**1,865**	**1,681**	**1,524**	**1,217**	**859**	**−753**	**−35**	**3,752**	**5,280**
Exports, f.o.b.	5,027	5,492	5,623	6,236	5,826	5,948	6,189	6,437	13,736	19,342	22,377	24,400
Imports, f.o.b.	5,646	4,481	4,127	4,371	4,145	4,424	4,971	5,578	14,489	19,377	18,626	19,120
Exports												
Agricultural	1,215	1,278	1,250	1,459	1,183	1,295	1,297	1,431	4,037	4,697	5,201	5,205
Extractive	1,200	1,306	1,401	1,547	1,382	1,368	1,418	1,451	2,827	4,791	5,455	5,620
Crude oil, products	1,008	1,080	1,153	1,281	1,150	1,111	1,150	1,189	2,249	4,111	4,522	4,600
Other extractive	192	226	248	267	232	257	268	262	579	680	933	1,020
Manufacturing	2,611	2,908	2,972	3,230	3,261	3,285	3,474	3,555	6,872	9,855	11,720	13,575
Textile yarn, fabrics	749	837	788	895	850	868	901	976	2,283	2,878	3,269	3,595
Clothing	466	529	578	605	576	624	691	708	1,057	1,732	2,177	2,600
Other manufacturing	1,397	1,542	1,605	1,730	1,835	1,793	1,881	1,871	3,531	5,245	6,274	7,380
Imports												
Foodstuffs	918	732	644	661	709	757	776	778	1,926	2,930	2,955	3,020
Grains	694	560	498	496	542	555	568	581	1,306	2,171	2,248	2,245
Other foodstuffs	223	172	146	166	167	202	209	197	620	759	707	775
Consumer durables	113	90	118	137	125	89	91	94	208	410	459	400
Industrial supplies	2,924	2,276	2,099	2,394	2,095	2,317	2,733	3,103	8,298	10,332	9,693	10,250
Textile fibers	755	422	378	444	375	425	475	525	1,138	2,158	1,998	1,800
Textile yarn, fabrics	385	373	354	443	285	292	304	318	295	850	1,556	1,200
Iron and steel	462	441	367	414	380	450	466	704	3,458	2,251	1,683	2,000
Other industrial supplies	1,322	1,041	1,000	1,094	1,055	1,150	1,488	1,556	3,407	5,074	4,457	5,250
Capital goods [c]	1,692	1,383	1,266	1,178	1,216	1,261	1,370	1,603	4,057	5,705	5,519	5,450
Machinery	1,259	1,039	970	843	750	830	921	1,099	2,532	3,883	4,111	3,600
Other capital goods	433	343	296	335	466	431	450	504	1,525	1,822	1,407	1,850

[a] Because of rounding components may not add to totals shown.
[b] Our 1982 projections combine partial trade partner data for the first quarter of 1982 with analyst judgments about the yearly totals for specific import and export commodities. Total exports, imports, and the trade balance are then built up from the component commodities.
[c] Includes some consumer durables such as televisions and small electrical appliances.

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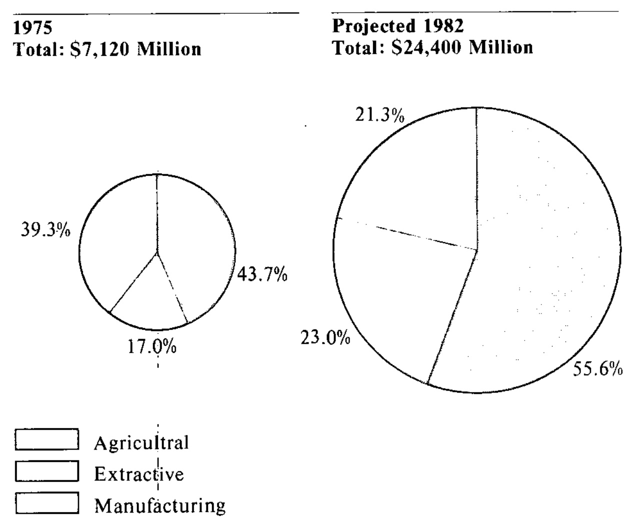
between 5 and 7 percent of GNP, up from the 2- to 3-percent average of the early 1970s. This export share of GNP now approaches that of other continental-size economies such as the United States, the Soviet Union, India, and Brazil—countries with sufficient domestic resources to satisfy most of the needs of their internal markets. Consumer goods fueled much of the recent growth in exports, but economic pressures are mounting on Beijing to boost the Chinese standard of living by diverting a smaller share of domestic output to exports. Furthermore, the world recession has reduced prices for energy and other natural resources, weakening China's incentive to expand the export of goods that are in great need at home. With sizable trade surpluses promising to keep foreign exchange reserves healthy, Beijing, we believe, no longer feels compelled to push exports so hard. [redacted] 25X

This was reflected in Beijing's recent decisions to establish an export licensing system and to impose export tariffs on certain commodities. Both actions were taken to prevent local exporters from selling goods that were in short supply at home. The export licensing requirement applies to at least 30 percent of China's exports, including petroleum, coal, and certain categories of iron and steel, nonferrous metals, chemicals, construction materials, and agricultural products. The tariffs were imposed on 34 commodities that together account for about 10 percent of China's export revenues. The new duties will reduce windfall profits that have been made by exporters in heavily subsidized industries and will prevent them from passing the subsidies along to foreign buyers by cutting prices below true costs of production. For most of the commodities, the tariff burden will be absorbed by the Chinese exporter, which may well hamper future export growth. [redacted]

Virtually all of the export growth this year will be from manufactures (see figure 3). Exports of *agricultural* commodities will stagnate, due partly to soft world prices and partly to increased consumption at home. The recently enacted export tariffs and the export licensing system, moreover, will affect agricultural exports the most, particularly rice, sugar, and soybeans. [redacted]

Figure 3
China: Exports, By Sector of Origin



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Although the long-term outlook for exports from the *extractive* sector—including minerals, metalliferous ores, coal, and oil—appears to be promising, the near-term prospects are for slow growth. [redacted] 25X

Inadequate rail and port capacity continues to constrain coal exports. Nevertheless, this year the volume of exports should increase to close to 8 million metric tons. The level of coal exports in relation to total coal production should also increase slightly, to near 1.3 percent. Japanese, European, and US firms are actively negotiating future joint development projects with the Chinese. Major agreements were signed earlier this year with two US firms concerning the development of China's potentially largest open pit mine—the Pingshuo Mine in Shanxi—and the expansion of China's oldest open pit mine—the Fushun west pit in Liaoning. Exports from these mines, however, will not come on stream until the mid-1980s. [redacted] 25X

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Beijing continues to give high priority to crude oil and petroleum product exports despite increased shortages at home. Petroleum exports netted $4.5 billion in 1981, 20 percent of total export earnings. Production is expected to remain essentially flat in 1982 but strong conservation measures combined with slow growth in energy-intensive industries may allow a slight growth in the volume of petroleum exports, especially higher valued petroleum products. We estimate, however, that price weakness will limit the value of such gains to only a few percent. A strong inducement to export, even when domestic industries run short of fuel, is the wide discrepancy between export and domestic prices. Crude oil sells for less than $15 a barrel in China, compared to $34 a barrel on the export market. [redacted]

Exports of *manufactured* goods will make the largest gains this year, as the Chinese continue to substitute exports of processed goods for raw materials wherever possible. Only a few manufactures—some chemicals, metals, and building materials—that are in short supply domestically will be affected by the export tariffs or licensing regulations. [redacted]

China's exports of textiles and apparel almost certainly will continue to expand in 1982. In addition to increasing the volume of exports, Beijing is selling more high-value products. As a result, clothing should account for a slightly larger share of textile-related exports in 1982 than in 1981. Sales to the United States should follow this trend, with the estimated value of 1982 clothing exports increasing as much as 20 percent, to nearly $500 million. Yarn and fabric sales could reach $270 million, an increase of 9 percent. US negotiators are in Beijing this month to renew a bilateral agreement that regulates growth in textile trade that could otherwise cut into the sales of US products. (For a short description of key US-China economic policy issues, see appendix B.) [redacted]

Import Prospects

We expect the dollar value of imports to grow about 3 percent this year, but all of this growth will be concentrated in the second half. Supplies to fuel an expansion of heavy industry and agriculture probably will be the first imports to recover. [redacted]

Imports of *foodstuffs* have generally gained as a result of the readjustment. With softening world prices, we expect further volume increases this year, but little increase in dollar value. We estimate that China's grain imports in 1982 will climb to roughly 14-15 million tons from last year's level of 13.2 million tons. Soybean imports should continue in a downward trend, however, because of a record domestic harvest.

[redacted]

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Consumer durables will continue to account for only a small share of imports, even if Beijing relaxes its campaign to cut "frivolous" foreign exchange expenditures (see figure 4). [redacted] 25X1

We do expect a significant upturn, however, for imports of many *industrial supplies*. Steel orders for delivery in the second half have increased about 20 percent. China is currently the biggest buyer in the world fertilizer market; purchases of insecticides and fungicides are also likely to jump. Imports of plastics and resins are continuing upward. Orders for wood, wood pulp, and kraftboard have resumed after a downturn last year. Imports of US lumber could double in 1982 to $200 million. [redacted] 25X1

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Imports of textile fibers, yarn, and fabric, on the other hand, probably will show a sharp decline in 1982. China has discontinued large-scale purchases of fibers and yarn, especially polyester and cotton, in order to reduce domestic inventories. US suppliers have been particularly hard hit, losing perhaps $300 million in orders. We expect imports to pick up in late 1982 after Beijing has had a chance to adjust reserves, balance new fiber and processing capacities, and reassess import requirements. Some purchases will be diverted to other suppliers, however, reducing US sales about 25 percent from last year's level, to $600

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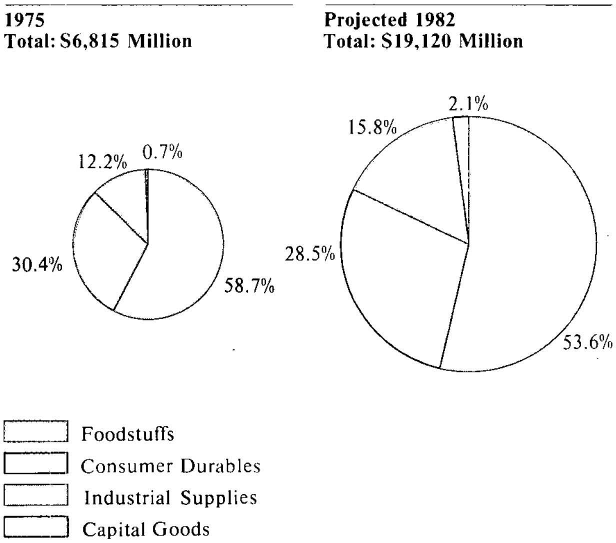
Figure 4
China: Imports, by End Use



[redacted]

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million in fibers and $200 million in yarn and fabrics. Unless the Chinese end their embargo on US cotton purchases, total US sales to China this year will be only two-thirds the 1981 level of 250,000 tons. [redacted]

The Chinese have resumed signing some whole-plant contracts with Japan, Western Europe, and Australia and have lifted the suspensions imposed on contracts early last year. The value of plant contracts signed so far has been modest, however, and lags in delivery will limit their impact on imports of *capital equipment* this year. Deliveries of various types of machinery for plants ordered in late 1978 and 1979 will continue to decline, but this will be partially offset by increased purchases of computers, electronic equipment, and oil-drilling equipment. [redacted]

Imports of transportation and communication equipment are also likely to increase. [redacted]

[redacted] Although foreign ship purchases are down from the record 1980 level, China is expected to continue buying needed vessels at favorable prices in the currently depressed world market, while building up a ship export business of its own. Purchases of motor vehicles in 1982 probably will be well above average. [redacted]

Chinese demand for imported oilfield equipment is rising substantially in 1982 as Beijing succeeds in channeling more funds into oil. The Ministry of Petroleum, for instance, is expected to purchase well over $100 million worth of drill pipe and tubing in 1982, most of it from Japan. Service account expenditures for seismic work and specialty contracts are also rising sharply. Oil industry equipment imports, however, such as production platforms for the Bohai Bay development, are increasingly being paid for by foreign joint venture firms and thus do not represent an outflow of foreign exchange. [redacted]

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Appendix B

Key Policy Issues Currently Affecting US-China Economic Relations

- ***US quotas on Chinese textiles*** are currently being negotiated in Beijing. The Chinese want higher levels than are now permitted under the present arrangements and have linked cotton purchases from the United States to US willingness to raise quota levels. Negotiations are expected to be extremely difficult and will take a long time to complete. [redacted]

- Under ***US antidumping regulations***, the International Trade Commission will hold hearings soon on allegations of unfair Chinese trade practices in regard to exports of greige goods and print cloth. [redacted]

- Beijing objects to ***US export controls***, particularly on semiconductors and computers, arguing that Washington has not followed its own stated policy on technology exports to China. [redacted]

[redacted]

- Until a ***Sino-US agreement on nuclear cooperation*** is reached, US firms will not be permitted to sell nuclear technology for the Shanghai and Guangdong power plants. China, as a nuclear weapons state, is demanding exclusion from safeguards and inspection controls required by US law. [redacted]

- China is a major source of refractory grade bauxite, titanium, tantalum, and beryllium needed for ***US strategic stockpiles***. The General Services Administration is considering proposing a barter agreement to obtain those materials. [redacted]

- The Internal Revenue Service has recently ruled that major provisions of ***China's tax on foreign enterprises*** are creditable against US taxes, clearing the way for US oil firms to bid on offshore oil leases. The IRS decision, however, did not address the creditability of Chinese taxes on subcontractors, a potential stumblingblock. [redacted] 25X

- Negotiations are scheduled to begin in Washington this month on a comprehensive ***bilateral income tax treaty*** that would eliminate double taxation of business profits, dividends, interest, capital gains, royalties, rentals, employment income, pensions, and other forms of income. Because of the vast differences in Chinese and US tax systems, the negotiations are likely to be drawn out. [redacted] 25X

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- China is drafting a patent law under which US firms could register their patents, but has not acceded to the Paris Convention on the Protection of Industrial Property. Although the Chinese abide by stipulations on proprietary knowledge written into commercial contracts, at present they have no legal obligation to honor ***US patents***. [redacted] 25X

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- Beijing is interested in a ***bilateral investment treaty*** proposed by the United States, which would ensure that expropriations of US-owned property would be accompanied by prompt, adequate, and effective compensation. The Chinese, however, may be reluctant to accept language in the US prototype treaty that extends "national" treatment to US firms and individuals—language that goes beyond the "most favored nation" treatment granted under the US-China Trade Agreement. [redacted] 25X

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